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May 8, 2003

DELIVERED ELECTRONICALLY

Susan Larsen, Deputy Director
Division of Public Utility Accounting
State Corporation Commission
1300 East Main Street
Richmond, VA 23219

Re: ***Commonwealth of Virginia, ex.rel. State Corporation Commission***
In the matter of developing consensus recommendations on stranded costs
Case No. PUE-2003-00062

Dear Susan:

To assist in achieving consensus, the Commission Staff has encouraged parties to discuss among themselves possible methods for calculating "just and reasonable net stranded costs" and their recovery. During the work group meeting on April 21, 2003, representatives of customers and competitors seemed to be coalescing, broadly speaking, around a single concept. Further discussion has allowed them to refine it further. Accordingly, Attachment I is submitted on behalf of the following interested parties: Virginia Committee for Fair Utility Rates, Old Dominion Committee for Fair Utility Rates (collectively, "the Committees"), TXI/Chaparral (Virginia) Inc., VML/VACo APCo Steering Committee, Virginia Citizens Consumer Council, Washington Gas Energy Services, Strategic Energy, Constellation New Energy, and Pepco Energy Services.

Attachment I reflects, with a minor change, the paper distributed by the Committees' counsel at the work group meeting on April 28, as well as key elements in the Committees' written comments of April 16.[1] The approach contained in Attachment I is reasonable and consistent with the Restructuring Act. You have referred to the approach to the calculation of just and reasonable net stranded costs included therein as the "Asset Valuation Methodology," and we will do so here.

The Commission Staff also has requested comments on the following issues: (i) Virginia Power's "clarifications" to its prior proposal; (ii) the Commission Staff's accounting proposal,

[1] In response to suggestions at the meeting on April 29, Attachment I reflects use of the term "revenue" in lieu of "net revenues" in lines one and three of the fourth bullet of the paper distributed at that meeting.

discussed at the April 29 meeting;[2] and (iii) requested action number 9 of the Legislative Transition Task Force ("LTTF"), relating to appropriate legislative or administrative actions to address any overrecovery or underrecovery of just and reasonable net stranded costs. Regarding each of these issues, the Committees offer the following comments.

I. Virginia Power's Clarifications to its Prior Proposal

As Attachment I indicates, Section 56-595.C (iii) of the Act requires the LTTF to monitor the over-recovery or under-recovery of just and reasonable net stranded costs,[3] and to do so, the LTTF must determine and compare two things: first, the amount that has been, or will be, available for recovery of just and reasonable net stranded costs, and, second, the amount of just and reasonable net stranded costs.

The Act, in Section 56-584, provides that two sources of revenue are available for recovery of just and reasonable net stranded costs -- capped rates and wires charges. Thus, the answer to the first side of the inquiry is straightforward: the amount that has been, or will be, available for recovery of such costs is the revenue collected from wires charges and capped rates in excess of the revenue needed by the utility to recover its costs of providing service (*i.e.*, the utility's revenues in excess of its revenue requirement).

Virginia Power's proposal, as clarified, still does not represent a "methodology for calculating 'just and reasonable net stranded costs,'" and it still does not calculate such costs. Nor does it, as clarified, calculate the amount available for their recovery. While it states that it would require an "annual" calculation of the "over-recovery" or "under-recovery" of "stranded costs *collected through wires charges*," its explanation of that "determination," as "clarified," reveals that it still does not calculate an "under-recovery or over-recovery" of stranded costs collected through wires charges.[4] Instead, Virginia Power merely proposes to calculate the difference between revenue collected from customers via wires charges and revenue that would have resulted if wires charges had been based on "actual" market prices experienced during the year. Thus, Virginia Power proposes to calculate the amount of revenue collected from wires charges, but not the over- or under-recovery of stranded costs recovered through wires charges. Virginia Power, moreover, proposes to ignore entirely any inquiry into the "under-recovery or over-recovery" of stranded costs through capped rates.

Thus, Virginia Power's proposal, as clarified, still fails to address the two sides of the inquiry required of the LTTF pursuant to Section 56-595.C (iii) of the Act as well as the directive

[2] Staff's proposal is called "Stranded Costs, an Accounting Perspective" (hereafter, "Accounting Proposal").
[3] Section 56-595.C (iii) of the Act provides that the members of the LTTF "shall: ... monitor ... whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs."
[4] Virginia Power's proposal, showing, in a black-line version, its recent "clarifications," is attached as Attachment II.

in the LTTF's Resolution, which parallels that Section of the Restructuring Act.[5] Virginia Power's proposal would calculate neither the amount of "just and reasonable net stranded costs" nor their over- or under-recovery through revenues from wires charges *and capped rates*.

Virginia Power's proposal, as clarified, still mentions expenses for "mitigating" potential stranded costs, and it further mentions "additional expenditures that negatively impact (increase) such costs during the transition period." A utility would calculate and report such expenses annually to the LTTF. Such calculations, however, do not provide a method to calculate just and reasonable net stranded costs or the means for their recovery. Thus, Virginia Power's proposal, as "clarified," continues to suffer from the same essential defects as those identified in the Committees' comments of April 16.

Virginia Power's "clarification" also recommends a calculation not included in its prior proposal – namely, an annual calculation of "the company's 'potential' stranded costs exposure under capped rates." Under this proposal, Virginia Power would compare "actual market prices experienced during the year to its unbundled generation rate" and, it states, determine the "potential revenue impact had all sales been made at those market prices rather than at capped generation rates." This calculation, Virginia Power asserts, would yield "potential stranded costs exposure during each year of the transition period." The Commission Staff has offered a similar proposal as part of its Accounting Proposal.[6]

The proposed calculation of annual stranded cost "exposure" is not a calculation of "stranded costs" or "just and reasonable net stranded costs," nor is it a calculation of the recovery of such costs through capped rates and wires charges. Thus, Virginia Power's proposal to calculate annual "exposure" to stranded costs may confuse, and potentially mislead, the inquiry required of the LTTF pursuant to Section 56-595 C (iii) of the Restructuring Act and the LTTF's Resolution. The useful lives of Virginia Power's generation assets are not one year in length. Nor, typically, are the terms of its purchased power agreements. On the contrary, the useful lives of such assets, and the terms of such agreements, typically are much longer than one year. Nor is it likely that all of Virginia Power's customers would take generation service from an alternative supplier at short-term energy prices for one year. The calculation, in short, misses the point. Requiring such an annual calculation, moreover, may lead to misperceptions about the extent to which a utility likely will over- or under-recover its just and reasonable net stranded costs. The proposal should not be adopted.

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[5] The LTTF's Resolution, in Requested Actions, number 2(b), requires the work group to present consensus recommendations regarding a "methodology to be applied in calculating each incumbent electric utility's just and reasonable net stranded costs, amounts recovered, or to be recovered, to offset such costs, and whether such recovery has resulted in or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs..."

[6] See, Staff's Accounting Proposal, page 1, the third bullet.

II. Staff's Accounting Proposal

Staff's Accounting Proposal, a copy of which is attached (Attachment III), would include a calculation of annual recoveries of stranded costs during the capped rate period based on the extent to which actual earnings exceed costs plus a fair return. The calculation of actual earnings would use an earnings test mechanism. Staff states that it would be "necessary to agree upon an appropriate fair rate of return to use as a benchmark ROE from which to measure earnings available for stranded cost recovery."

As indicated in Attachment I, the earnings test that would be applied by the Staff in its review of utilities' annual informational filings would be an acceptable means of measuring the revenue available for recovery of stranded costs.

Staff also proposes that "potential stranded cost exposure" also be calculated. Staff defines "potential stranded cost exposure" as "the annual stranded cost exposure during the capped rate period, assuming all customers are paying market rates for generation service." Thus, as indicated above, Staff proposes a calculation of "potential stranded cost exposure" that is similar to that proposed by Virginia Power, and Staff's proposal suffers from the same deficiencies as those identified above in connection with Virginia Power's proposal.

Staff proposes that during the capped rate period comparisons can be made between stranded cost recoveries and potential stranded cost exposure. While information regarding revenue available for recovery of stranded cost is essential to determining over- or under-recovery of such costs, it is not clear what, if any, additional "insight" into the likelihood of over- or under-recovery of stranded costs is gained by annual calculation of such "exposure."

III. Recommendations for Legislative or Administrative Action

The LTTF's Resolution requests that the Commission include in its report to the LTTF "any recommendation for legislative or administrative action that the Commission, the work group, or both, determine to be appropriate in order to address any overecovery or underrecovery of just and reasonable net stranded costs."

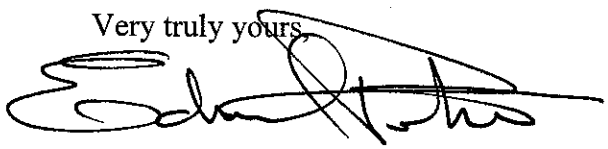
The calculation and recovery methodologies described on Attachment I are likely to produce over-recoveries of just and reasonable net stranded costs. The Restructuring Act does not specify how the LTTF should address any over- or under-recovery of just and reasonable net stranded costs that emerges from its monitoring.

One consequence of the over-recovery of such costs should be recommendations for the repeal of the Restructuring Act's provisions requiring the imposition of wires charges on customers that purchase power from alternative generation suppliers. As indicated in the Committees' initial comments in this matter, dated March 21, 2003, the wires charges afford one

of the two means of recovery of just and reasonable net stranded costs; however, if the incumbent utility's capped rates and wires charges are over-recovering such costs, any justification for the imposition of wires charges on such customers would be eliminated. Therefore, the Committees' recommend consideration of the elimination of wires charges, and, if appropriate, a reduction in capped rates if the LTTF concludes from its monitoring of just and reasonable net stranded costs and their recovery that revenue from capped rates and wires charges is likely to result in an over-recovery of such costs.

We appreciate the opportunity to comment and hope the above is helpful. Please contact me if you have any questions concerning this submittal.

Very truly yours,



Edward L. Petrini

cc: State Corporation Commission
Division of Economics and Finance
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ATTACHMENT I

Submitted on behalf of the following:
Virginia Committee for Fair Utility Rates, Old Dominion Committee for Fair Utility Rates, TXI/Chaparral (Virginia) Inc., VML/VACo APCo Steering Committee, Virginia Citizens Consumer Council, Washington Gas Energy Services, Strategic Energy, Constellation New Energy, and Pepco Energy Services

- Section 56-595.C (iii) of Virginia's Electric Utility Restructuring Act ("Act") provides that the members of the Legislative Transition Task Force ("LTTF") " ... shall: ... monitor ... whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs.

- To monitor an "over-recovery" or "under-recovery," the LTTF must determine and compare two amounts: first, the amount that has been, or will be, available for recovery of just and reasonable net stranded costs, and, second, the amount of just and reasonable net stranded costs.

- Section 56-584 of the Act provides for two sources of revenue for the recovery of just and reasonable net stranded costs -- capped rates and wires charges.

- Thus, the amount that has been, or will be, available for recovery of such costs is the revenue collected from wires charges and capped rates. Because the incumbent utility must collect sufficient revenue to recover its costs of providing service, the revenue available for the recovery of just and reasonable net stranded costs is the revenue from capped rates and wires charges in excess of the revenue needed by the utility to recover its costs of providing service (*i.e.*, the utility's revenues in excess of its "revenue requirement").

- The following approach recognizes both sides of the inquiry required of the LTTF – *i.e.*, (i) the amount of just and reasonable net stranded costs and (ii) the amount available for recovery of such costs through wires charges and capped rates.

  > To calculate just and reasonable net stranded costs compare asset values based on the net present value of the difference between the revenues that arise from remaining in a regulated market (cost plus a fair return) and the revenues that arise in a competitive market (over the life of the assets). From this amount subtract revenues via capped rates (to the extent capped rates exceed actual and likely costs including a fair return) and wires charges to determine the over- or under-recovery of just and reasonable net stranded costs.

- The above approach represents an acceptable, administrative methodology for the calculation of both just and reasonable net stranded costs and their recovery under the Act. By reference to the "regulated market (cost plus a fair return)," the methodology incorporates traditional ratemaking concepts in a regulated environment, including consideration of a utility's regulated cost of service used in setting "just and reasonable" rates, and including concepts of "prudence," mitigation, verification, and the "netting" of stranded costs and margins. The methodology properly requires consideration of the useful life of assets.

- As is true of any administrative method of determining stranded costs, the above approach involves estimates based on long-term revenue and cost projections. Such estimates are data-intensive and highly sensitive to the underlying assumptions and models used in making them. Long-term projections, however, are almost always used, implicitly or explicitly, in valuing assets for commercial purposes. Reasonable forecasts of items affecting such calculations and the development of estimates under reasonable scenarios would be required.

- Incumbent electric utilities must make annual informational filings ("AIFs") that include specified financial information with the State Corporation Commission. The Commission reviews such

AIFs for compliance with Commission requirements for accounting and ratemaking treatment of costs and revenues. As approved by the Commission, AIFs would provide an acceptable basis for calculating a utility's historical cost of providing service and any revenues in excess of those costs that may be available for recovering stranded costs.

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ATTACHMENT II

~~The~~**Dominion Virginia Power's proposed** methodology for ~~calculating~~**monitoring** "just and reasonable net stranded costs" ~~requires~~**would require** a utility to ~~determine (1)~~ **calculate and report to the LTTF, for each year of the transition period, (1)** whether there ~~is~~**was an** over- or under-recovery of stranded costs collected through the wires charges from switching customers~~, and (2)~~ **and, if so, the amount thereof, (2) the company's actual "above-market" or "potential" stranded costs exposure under capped rates, (3)** the amounts it has expended from funds available under capped rates to mitigate potential stranded costs, ~~less any~~ **and (4)** additional expenditures that negatively impact **(increase)** such costs **during the transition period**. ~~Under~~

To make the determination required under (1), a company ~~can~~**would** compare the revenue ~~actually~~ collected annually from customers via the wires charges**,** based on **the** projected market prices **established by the Commission,** to the revenue that would have resulted had wires charges been based on the actual market prices experienced during that year**. Projected market prices are based on actual forward market transactions and information prevailing at the time the Commission establishes wires charges, if any, to be in effect for the next calendar year. Actual market prices are based on actual market transactions ("settlement" or "spot" prices) and information prevailing at the time the energy could be delivered for sale**. If the revenue collected through the wires charges was greater than the revenue that would have resulted had the actual market price been correctly predicted, the wires charges were set

too high, resulting in an over-recovery for that year. If the contrary ~~is~~**was** the case**,** then there ~~is under-recovery. In any event, whether the above two measures produce an~~**was an under-recovery.**

Under (2), a utility would track the annual potential stranded costs exposure associated with customers still paying capped rates during the transition period. After the close of each year, the Company would compare actual market prices experienced during that year (using the same data as above) to the Company's unbundled generation rate, and a determination would be made of the potential total revenue impact had all sales been made at those market prices rather than at capped generation rates. This calculation would yield the potential stranded costs exposure during each year of the transition period.

Under (3), a utility would annually report to the LTTF the amounts it has expended for mitigation of potential stranded costs and, in (4), expenditures that add to potential stranded costs.

While these measures will provide the LTTF with annual information to monitor stranded cost recovery and the Company's potential stranded cost exposure, the over- or under-recovery of a utility**'**s total stranded costs cannot be finally determined until after July 1, 2007. **Until that date, the market prices existing at the end of the transition period cannot be determined.**

ATTACHMENT III

Stranded Costs – An Accounting Perspective

An alternative method that would indicate annual recoveries of stranded costs throughout the transition period is an accounting approach based on an earnings test mechanism. This mechanism could also be used to calculate the level of potential stranded cost exposure existing during each earnings test year. This approach would not provide for an upfront calculation of what total stranded costs are estimated to be, but could work in conjunction with the other proposed methods by providing stranded cost recovery information.

It is important to define stranded cost terms relative to this accounting approach:

- **Recovery of stranded costs**: Recovery of stranded costs occurs throughout the capped rate period to the extent actual earnings exceed costs plus a fair return. These recoveries can be calculated and monitored using the earnings test mechanism.

- **Actual stranded costs**: Defined as the underrecovery of just and reasonable generation costs in a competitive environment. Actual stranded costs would occur after the termination of capped rates and wires charges if actual generation costs exceed market prices.

- **Potential stranded costs**: Defined as the annual stranded cost exposure during the capped rate period, assuming all customers are paying market rates for generation service. This amount is represented by the difference between the recalculated, cost-based unbundled generation rates (at a fair return) less the actual market rate for the applicable year, times total annual sales.

Earnings test information is already required to be filed by IOU's under the Commission's existing rate case rules and AIF requirements. Earnings tests only

recognize limited accounting or regulatory adjustments to per book amounts, and do not encompass going forward adjustments. Generally, earnings test adjustments restate per book results in order to reflect differences between GAAP and how costs are recognized for ratemaking purposes. It would be necessary to agree upon an appropriate fair rate of return to use as a benchmark ROE from which to measure earnings available for stranded cost recovery.

A bundled earnings test should be used until such time as bundled, capped rates are terminated. It is proper to use a bundled earnings test since all earnings produced under bundled, capped rates that are in excess of actual costs plus a fair return can be used to mitigate stranded cost exposure.

The determination of potential stranded costs will require a functionalized cost of service study that separates out the generation business. The cost of service study would incorporate the earnings test adjustments applicable to the test period. Actual generation costs for the test year including a fair return would then be used to calculate current, cost-based, unbundled generation rates by customer class. These generation rates would be compared to market-based rates applicable to the test year to calculate the potential stranded cost exposure for that year.

Throughout the transition period, comparisons can be made between stranded cost recoveries and potential stranded cost exposure. This will provide insight into the success of mitigation efforts, and the likelihood of whether an over or underrecovery of stranded costs will occur. By the end of the capped rate period, the earnings tests will have quantified the cumulative net recoveries of stranded costs, and we will be able to more accurately determine any stranded cost exposure going forward at that time, based on the same potential stranded cost calculations. Continued earnings monitoring after the termination of capped rates on the unbundled generation business could provide a calculation of actual stranded costs or benefits on an annual basis.

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